
Summary

The economic recession and recent laws have combined to sharply reduce the budget surpluses projected a year ago. In January 2001, the Congressional Budget Office (CBO) projected that under the laws and policies then in force, the federal government would run surpluses in fiscal years 2002 through 2011 totaling \$5.6 trillion.¹ In CBO's new projections, that cumulative surplus has fallen to \$1.6 trillion—a drop of \$4 trillion (see Summary Table 1).

About 60 percent of that decline results from legislation—primarily the tax cuts enacted in June and additional discretionary spending—and from its effect on the cost of paying interest on the federal debt. Changes in the economic outlook and various technical revisions since last January account for the other 40 percent of that decline.

For both 2002 and 2003, CBO now projects that, instead of surpluses, the total budget will show small deficits, if current policies remain the same and the economy follows the path that CBO is forecasting. In 2001, by contrast, the federal government ran a surplus of \$127 billion (see Summary Table 2).

The deficit projected for this year—\$21 billion—represents a change of more than \$300 billion from last January's projection. Over 70 percent of that reduction results from the weak economy and related

technical factors, which have considerably lowered the revenues expected for this year and next.

For the current 10-year projection period, 2003 through 2012, CBO estimates a total surplus of nearly \$2.3 trillion. However, almost half of that total comes from the surpluses projected for 2011 and 2012—the last two years of the projection period and thus the most uncertain. The surpluses for those years also reflect the scheduled expiration in December 2010 of the tax cuts enacted last June.

In CBO's new baseline, the off-budget accounts (which reflect the spending and revenues of Social Security and the Postal Service) run surpluses throughout the projection period. In the on-budget accounts, by contrast, surpluses do not reemerge until 2010.

CBO's baseline projections are intended to serve as a neutral benchmark against which to measure the effects of possible changes in tax and spending policies. They are constructed according to rules set forth in law and long-standing practices and are designed to project federal revenues and spending under the assumption that current laws and policies remain unchanged. Thus, these projections will almost certainly differ from actual budget totals: the economy may not follow the path that CBO projects, and lawmakers are likely to alter the nation's tax and spending policies. Therefore, CBO's baseline should be viewed not as a forecast or prediction of future budgetary outcomes but simply as the agency's best judgment of how the economy and other factors will affect federal revenues and spending under current law.

1. That projection appeared in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002-2011* (January 2001).

Summary Table 1.
Changes in CBO's Baseline Projections of the Surplus Since January 2001 (In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total, 2002- 2006	Total, 2002- 2011
Total Surplus as Projected in January 2001	313	359	397	433	505	573	635	710	796	889	2,007	5,610
Changes												
Legislative												
Tax act ^a	-38	-91	-108	-107	-135	-152	-160	-168	-187	-130	-479	-1,275
Discretionary spending	-44	-49	-52	-54	-56	-57	-58	-59	-60	-61	-255	-550
Other	-4	-6	-5	-3	-4	-2	-2	-2	-2	-2	-23	-33
Debt service ^b	-5	-12	-22	-32	-44	-57	-72	-88	-106	-124	-114	-562
Subtotal	-91	-158	-186	-197	-238	-268	-293	-317	-355	-317	-870	-2,420
Economic	-148	-131	-95	-81	-75	-75	-76	-79	-82	-88	-530	-929
Technical ^c	-94	-84	-62	-51	-64	-64	-65	-64	-65	-45	-356	-660
Total Changes	-333	-373	-343	-330	-377	-406	-433	-460	-502	-450	-1,757	-4,008
Total Surplus or Deficit (-) as Projected in January 2002	-21	-14	54	103	128	166	202	250	294	439	250	1,602
Memorandum:												
Changes in the Surplus by Type of Discretionary Spending												
Defense	-33	-29	-29	-29	-29	-29	-30	-30	-31	-32	-149	-301
Nondefense	-11	-20	-23	-25	-26	-28	-28	-29	-29	-30	-106	-249

SOURCE: Congressional Budget Office.

NOTE: For purposes of comparison, this table shows projections for 2002 through 2011 because that was the period covered by CBO's January 2001 baseline. The current projection period extends from 2003 through 2012.

- The Economic Growth and Tax Relief Reconciliation Act of 2001, which was estimated at the time of enactment to reduce revenues by \$1,186 billion and increase outlays by \$88 billion between 2002 and 2011.
- Reflects only the change in debt-service costs that results from legislative actions. Other effects on debt-service costs are included under economic and technical changes.
- Technical changes are revisions that are not attributable to new legislation or to changes in the components of CBO's economic forecast.

The Budget Outlook

If current policies remain in place, CBO projects, the total budget will be in deficit for the next two years. Those deficits are expected to be small, amounting to only 0.2 percent of the nation's gross domestic product (GDP) in 2002 and 0.1 percent of GDP in 2003 (see Summary Table 2). After that, surpluses are projected to reemerge and gradually increase.

For the five years from 2003 through 2007, CBO projects a cumulative surplus of \$437 billion. That figure represents off-budget surpluses totaling more than \$1 trillion offset by on-budget deficits that total \$617 billion. For the 10-year period through 2012, the total budget surplus under current policies is projected to approach \$2.3 trillion. Again, that amount is made up of surpluses in Social Security (\$2.5 trillion) offset by a cumulative on-budget deficit (\$242 billion). Without the scheduled expiration

Summary Table 2.
The Budget Outlook Under Current Policies (In billions of dollars)

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003- 2007	Total, 2003- 2012
On-Budget Surplus or Deficit (-)	-33	-181	-193	-141	-108	-99	-76	-56	-23	4	131	319	-617	-242
Off-Budget Surplus ^a	<u>161</u>	<u>160</u>	<u>178</u>	<u>195</u>	<u>212</u>	<u>227</u>	<u>242</u>	<u>258</u>	<u>274</u>	<u>290</u>	<u>307</u>	<u>322</u>	<u>1,054</u>	<u>2,505</u>
Total Surplus or Deficit (-)	127	-21	-14	54	103	128	166	202	250	294	439	641	437	2,263
Debt Held by the Public (End of year)	3,320	3,380	3,410	3,373	3,288	3,177	3,027	2,840	2,605	2,325	1,900	1,273	n.a.	n.a.
Memorandum:														
Total Surplus or Deficit (-) as a Percentage of GDP	1.3	-0.2	-0.1	0.5	0.8	1.0	1.2	1.4	1.7	1.9	2.7	3.7	0.7	1.6
Debt Held by the Public (End of year) as a Percentage of GDP	32.7	32.8	31.3	29.2	27.0	24.8	22.5	20.0	17.5	14.8	11.5	7.4	n.a.	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds and the net cash flow of the Postal Service.

of last June's tax cuts, the total 10-year budget surplus would fall to \$1.6 trillion.

The total surplus is projected to equal 1 percent of GDP by 2006 and grow to 3.7 percent of GDP by 2012. Estimates of large surpluses should be viewed cautiously, however, because future economic developments and estimating inaccuracies could change the outlook substantially. In addition, future legislative actions are almost certain to alter the budgetary picture.

Changes in the Past Year

As an illustration of how quickly the budget outlook can change, CBO's projection of the cumulative surplus for 2002 through 2011 has plunged by \$4 trillion

in just one year (see Summary Table 1).² Some \$2.4 trillion of that drop can be attributed to legislative actions. The legislation with the largest effect was the Economic Growth and Tax Relief Reconciliation Act of 2001, enacted in June. That law is estimated to reduce surpluses by nearly \$1.3 trillion over 10 years (not including associated debt-service costs).

Additional discretionary spending since last January accounts for another \$550 billion reduction in the projected surplus for the 2002-2011 period. That amount stems from both regular and supplemental appropriations. CBO's January 2001 baseline assumed that discretionary budget authority for 2002

2. About 45 percent of that reduction results from changes made since CBO issued its updated *Budget and Economic Outlook* in August 2001. The drop since August totals \$1.8 trillion and is attributed, in relatively equal measures, to legislative, economic, and technical changes.

would total \$665 billion.³ The actual amount appropriated for 2002 in the 13 regular appropriation acts totaled \$691 billion. In addition, the Congress and the President enacted \$20 billion in supplemental budget authority in December as part of their response to the terrorist attacks of September 11—thereby generating a total of \$711 billion in budget authority for 2002, \$45 billion more than CBO assumed last January.

Under the provisions of the Balanced Budget and Emergency Deficit Control Act of 1985, CBO's baseline assumes that annual appropriations for discretionary programs continue at their current level, increasing only by the rates of inflation projected for each year. As a result of the appropriations enacted for 2002, projections of discretionary spending in the current baseline begin at a level that is \$45 billion higher than a year ago.

Furthermore, two supplemental appropriation laws enacted in fiscal year 2001—one for defense personnel and readiness programs and another in immediate response to the attacks of September 11—will generate outlays totaling around \$25 billion in 2002 and beyond. However, budget authority from actions in 2001 is not carried forward into the baseline projections for future years because those appropriations occurred before the current year.

Overall, legislated reductions in revenues, additional discretionary spending, and other laws with smaller budgetary effects have reduced projected surpluses—and thereby increased the government's borrowing needs—by \$1,858 billion for 2002 through 2011. That increased borrowing is projected to result in an extra \$562 billion in net interest costs over the 10-year period.

Changes in the economic outlook since January 2001 account for another \$929 billion decline in the 10-year surplus. About three-quarters of that total reflects lower revenue projections, mostly resulting from the substantially weaker economic growth expected in the near term and the slightly lower average growth rates projected for the following several

years. Much of the rest of the decline attributable to the economic outlook represents added debt-service costs resulting from the reduction in anticipated revenues.

Technical changes—those not driven by new legislation or by changes in CBO's economic forecast—have reduced the projected 10-year surplus by a total of \$660 billion since last January. As with the economic changes, revenues account for over 75 percent of the technical changes, and debt service accounts for much of the rest. The technical changes to revenues stem primarily from revised projections of capital gains realizations and adjustments for lower-than-expected tax collections in recent months.

Homeland Security

Since the attacks of September 11, federal agencies, state and local governments, and the private sector have perceived a heightened threat to the United States and a need to commit more resources to homeland security. On the federal level, legislation following the attacks increased the budget authority provided for such security from \$17 billion in 2001 to \$22 billion for 2002. What level of resources to commit to homeland security will undoubtedly be a key issue as the Congress and the President make decisions about spending and other policies this year.

The Outlook for Federal Debt

In the January 2001 *Budget and Economic Outlook*, CBO estimated that federal debt held by the public would reach a level in 2006 that would allow the Treasury to retire all of the debt available for redemption. At that time, CBO also projected that the statutory ceiling on all federal debt (which includes debt held by government accounts) would not be reached until 2009. Now, CBO estimates that debt held by the public will not be fully redeemed within the 10-year projection period and that the current debt ceiling will be reached in the next few months. Nevertheless, if the surpluses projected in the current baseline materialize, debt held by the public will fall to about 15 percent of GDP in 2010—its lowest level since 1917.

3. That figure was calculated by assuming that the amount appropriated for the base year of 2001 would grow at specified rates of inflation.

The Economic Outlook

In CBO's view, the most likely path for the economy is a mild recession that may already have reached its nadir. CBO expects the annual growth rate of real (inflation-adjusted) GDP to accelerate from -0.2 percent in 2001 (measured from the fourth quarter of calendar year 2000 to the fourth quarter of 2001) to 2.5 percent in 2002 and to accelerate further to 4.3 percent in 2003 (see Summary Table 3).

Some unusual features of the current recession will cause it to be mild, CBO believes. Chief among those features are the rapidity of policymakers' responses, the moderating behavior of prices, and an early reduction in businesses' inventories. In less than one year, the Federal Reserve has cut the federal funds rate 11 times—from 6.5 percent to 1.75 percent. Also, the tax cuts enacted in June prevented consumption from slowing more than it might have otherwise, and additional federal spending in response to the terrorist attacks will boost GDP in 2002. Lower prices for oil and natural gas and mild price increases for other items are supporting con-

sumption by boosting real disposable income. Furthermore, businesses began to reduce inventories earlier in this recession than they did in past downturns, which may mean that fewer cuts in inventories remain than at this stage of the typical recession.

CBO projects that weak demand in the short run will translate into weak employment, pushing the unemployment rate higher for the next several quarters while restraining inflation. With growth of real GDP near zero early this year, the unemployment rate is expected to increase to 6.1 percent in calendar year 2002 from 4.8 percent last year. The rate of inflation faced by consumers is forecast to fall from 2.9 percent last year to 1.8 percent in 2002. Lower oil prices account for most of the projected decline in inflation, although the recession also plays a role. As oil prices stabilize in CBO's forecast, inflation bounces back to 2.5 percent in 2003.

Looking out through 2012, CBO expects the growth of real GDP to average 3.1 percent during the 2002-2012 period—roughly the same rate that CBO projected last January for the 2002-2011 period. Nonetheless, the level of real GDP is lower each year

Summary Table 3.
CBO's Economic Forecast for 2002 and 2003

	Estimated 2001	Forecast	
		2002	2003
Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP	1.7	4.2	6.5
Real GDP	-0.2	2.5	4.3
Calendar Year Average			
Real GDP (Percentage change)	1.0	0.8	4.1
Consumer Price Index (Percentage change) ^a	2.9	1.8	2.5
Unemployment Rate (Percent)	4.8	6.1	5.9
Three-Month Treasury Bill Rate (Percent)	3.4	2.2	4.5
Ten-Year Treasury Note Rate (Percent)	5.0	5.0	5.5

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

a. The consumer price index for all urban consumers.

than in last January's projections, primarily because actual GDP ended up much lower in 2001 than CBO had expected a year ago.

Uncertainty of the Projections

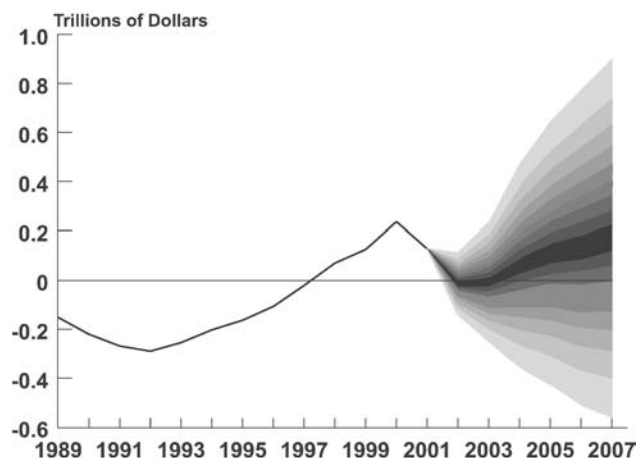
CBO's baseline projections represent the midrange of possible outcomes based on past and current trends and the assumption that current policies remain the same. But considerable uncertainty surrounds those projections for two reasons. First, future legislation is likely to alter the paths of federal spending and revenues. CBO does not predict legislation—indeed, any attempt to incorporate future legislative changes would undermine the usefulness of the baseline as a benchmark against which to measure the effects of such changes. Second, the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to predict. As a result, actual budgetary outcomes will almost certainly differ from CBO's baseline projections.

In view of such uncertainty, the outlook for the budget can best be described as a fan of probabilities around the point estimates presented in this report (see Summary Figure 1). Not surprisingly, those probabilities widen as the projection period extends. As the fan chart makes clear, projections that are quite different from the baseline have a significant probability of coming to pass.

The Long-Term Outlook

Despite the sizable surpluses projected for the later years of CBO's 10-year budget outlook, long-term pressures on spending loom just over the horizon. Those pressures result from the aging of the U.S. population (large numbers of baby boomers will start becoming eligible for Social Security retirement benefits in 2008 and for Medicare in 2011), from increased life spans, and from rising costs for federal health care programs. According to midrange esti-

Summary Figure 1.
Uncertainty in CBO's Projections of the Total Budget Surplus Under Current Policies



SOURCE: Congressional Budget Office.

NOTES: This figure shows the estimated likelihood of alternative projections of the surplus under current policies. The calculations are based on CBO's past track record. CBO's baseline projections fall in the middle of the darkest area. Under the assumption that policies do not change, the probability is 10 percent that actual surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual surpluses will of course be affected by legislation enacted during the next 10 years, including decisions about discretionary spending. The effects of future legislation are not included in this figure.

An explanation of how this probability distribution was calculated will appear shortly on CBO's Web site (www.cbo.gov).

mates, if current policies continue, spending on Social Security, Medicare, and Medicaid combined will nearly double by 2030, to almost 15 percent of GDP.

Taking action sooner rather than later to address long-term budgetary pressures can make a significant difference. In particular, policies that encourage economic growth—such as running budget surpluses to boost national saving and investment, enacting tax and regulatory policies that encourage work and saving, and focusing more government spending on investment rather than on current consumption—can help by increasing the total amount of resources available for all uses.